CHAPTER 12

FINANCIAL INSTITUTIONS

Part A. Commercial Banks and Thrift Institutions

This Part discusses proposals to conform special rules relating t the taxation of banks and thrift institutions to the general rules for the taxation of corporate income. The special bad debt reserve deduction for banks and thrift institutions would be repealed. Interest allocable to tax-exempt obligations held by banks, savings and loans, and certain other thrift institutions would be deductible. The tax exemption of credit unions and special reorganization rules for failing thrift institutions would be repealed.

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REPEAL SPECIAL RULES FOR BANK BAD DEBT DEDUCTIONS

General Explanation

Chapter 12.01

Current Law

Commercial banks and thrift institutions are generally subject to the corporate income tax, but receive preferred tax treatment that permits them to deduct additions to reserves for bad debts using a method unrelated to their actual loan loss experience.

Commercial banks may utilize either the percentage method or a modified version of the experience method for determining their bad debt deductions. The percentage method allows a current deduction for additions to reserves sufficient to maintain a reserve of up to 0.6 percent of eligible loans outstanding. The experience method for banks generally is based on average loan losses over the most recent six-year period. Banks need not be consistent in their choice of method from one taxable year to another. The provision permitting use of the percentage method is scheduled to expire at the end of 1987, at which time all commercial banks must use the experience method.

Thrift institutions may use modified versions of the percentage method or experience method available to banks. Alternatively, thrift institutions, if they hold sufficient amounts of their assets in certain eligible investments (primarily residential mortgages), may elect the percentage of taxable income method for purposes of establishing their bad debt reserves for qualifying real property loans. Savings and loan associations and stock savings banks must hold at least 82 percent of their total assets in eligible investments to receive the maximum deduction, which is equal to 40 percent of taxable income (computed with certain modifications). A lower percentage of taxable income is deductible if less than 82 percent of total assets constitute eligible investments. Mutual savings banks must hold at least 72 percent of their total assets in eligible investments to receive the maximum deduction, which is also subject to reduction if the percentage of eligible investments is less than 72 percent.

Thrift institutions that utilize the percentage of taxable income method are limited in the amounts of certain other tax benefits they may claim. For example, they may claim only one-half of the otherwise-allowable investment tax credit and their dividends-received deduction is reduced from that available to other corporations.

The corporate preference item reduction provisions reduce the amount of bad debt reserve deductions that a depository institution not on the experience method may claim. No deduction is allowed for an amount equal to 20 percent of the excess of a depository institution's addition to its bad debt reserves over the additions that would have been deductible had the institution used the experience method. In addition, an amount equal to 59-5/6 percent of such excess constitutes a tax preference item for purposes of the corporate minimum tax.

Reasons for Change

Current law provides more favorable tax treatment of bad debt losses to depository institutions than to lenders in other industries. This tax preference distorts the investment decisions of some depository institutions. A thrift institution may utilize the favorable percentage of taxable income method only if it specializes in residential mortgage lending. The maximum deduction is available only if 82 percent of the thrift's assets (72 percent for mutual savings banks) are invested in loans on residential real estate, liquid assets, or certain other assets. The linkage between a lower effective tax rate and residential mortage lending provides a disincentive to diversification by thrift institutions and thereby subjects thrifts to increased portfolio risk.

Finally, the special percentage of taxable income deduction benefits only profitable thrift institutions. Thrifts with no taxable income must elect the percentage of eligible loan method to maximize their net operating losses. Thus, the special bad debt deduction tied to residential mortgage lending benefits only a fraction of all mortgage lenders.

Proposal

The special rules for commercial banks and thrift institutions for computing additions to a bad debt reserve would be repealed. Depository institutions would be subject to the general rule applicable to all taxpayers. The Treasury Department proposals would require generally that bad debt losses be deducted only as they occur. See Chapter 10.04. This requirement would apply equally to commercial banks and thrift institutions.

Effective Date

The proposal would be effective for all taxable years beginning on or after January 1, 1986. Depository institutions would be required to include existing reserves in income over ten years, starting with the first taxable year beginning on or after January 1, 1986.

Analysis

Deductions for additions to reserves for bad debts are overstated for depository institutions compared to deductions for bad debts for other businesses. Because a bad debt reserve for tax purposes involves only bookkeeping entries with no set-aside of assets, the only practical effect of present law is to increase the after-tax income of depository institutions. The lower effective tax rate resulting from excess bad debt deductions subsidizes loans from depository institutions and enables them to offer loans at artificially low rates. The proposal would eliminate this subsidy.

The proposal would reduce the amount of bad debt deductions reported by depository institutions. Present law permits depository institutions to select from a variety of methods the one providing the largest deductions. For example, the percentage of eligible loan reserve method permits a bank to maintain a reserve equal to 0.6 percent of its outstanding loans without regard to actual loss experience. Thus, it only benefits banks with bad debt experience rates below that level; banks with higher bad debt rates will utilize the experience reserve method. In 1983, an estimated 73 percent of commercial banks found the percentage method to be more beneficial (actually, more used it because of special transition rules), while only 27 percent found the experience method to be more advantageous.

Excess deductions for additions to bad debt reserves by thrift institutions under the percentage of taxable income method reduce their effective marginal tax rates. Most thrift institutions were unable to take advantage of the percentage of taxable income method in 1981 and 1982 because they did not have taxable income. Only profitable thrift institutions derive any benefit from the percentage of taxable income method permitted under current law. For example, the total bad debt deductions claimed by savings and loan associations fell from $1.41 billion in 1979 to $0.14 billion in 1981, because the preferential tax treatment is tied to profits, not actual loan losses. In 1983, an estimated 60 percent of savings and loans found the percentage of taxable income method to be beneficial (actually, fewer did because of net operating loss carry forwards), while the remaining 40 percent found the percentage of outstanding loans method to be more beneficial.

Additional analysis of the proposed repeal of the reserve method for all bad debt deductions is provided in Chapter 10.04.

Ninety-seven percent of all savings and loan associations and 64 percent of all commercial banks had loss-to-loan ratios below the percentage method's allowable 0.6 percent. Also in 1983, 99 percent of all savings and loan associations and 58 percent of all commercial banks wrote off for financial reporting purposes less than 0.6 percent of their outstanding loans. The special bad debt reserve rules are clearly a large subsidy for most savings and loan associations and commercial banks and a significant distortion from the measurement of economic income.

DENY DEDUCTION FOR INTEREST TO CARRY TAX-EXEMPT BONDS

General Explanation

Chapter 12.02

Current Law

Current law generally denies a deduction to any taxpayer for interest on indebtedness incurred or continued to purchase or carry tax-exempt obligations. Whether indebtedness is incurred or continued to purchase or carry tax-exempt obligations is based on the taxpayer's purpose in incurring indebtedness while holding tax-exempt obligations, as indicated by the facts and circumstances of the particular case.

Until 1982, banks, thrifts, and certain other financial institutions could invest their depository funds in tax-exempt obligations without losing the deduction for interest paid on their deposits or short-term obligations. Under current law, however, such financial institutions are denied 20 percent of their interest deduction allocable to indebtedness (including deposits and other short-term obligations), incurred or continued in order to purchase or to carry tax-exempt obligations acquired after 1982. A statutory presumption treats a portion of a bank's or other financial institution's indebtedness as allocable to tax-exempt obligations in an amount equal to the ratio of (i) the average adjusted basis over the year of all tax-exempt obligations (acquired after 1982) held by the bank or financial institution to (ii) the average adjusted basis over the year of all assets held by the bank or financial institution.

The corporate mimimum tax generally does not apply to interest received by banks and financial institutions from the holding of tax-exempt obligations.

Reasons for Change

Basic measurement of income principles require that income be matched with the costs of its production. In line with these principles, the costs of producing tax-exempt income, including interest expense incurred to carry tax-exempt bonds, are properly nondeductible. Since the income to which such costs are attributable is exempt from tax, disallowance of a deduction is necessary to prevent the taxpayer from offsetting other nonexempt income.

The exception from the above principles for interest paid or incurred by commercial banks and thrifts has enabled these institutions to hold a substantial portion of their investment portfolios in tax-exempt obligations, substantially reducing their Federal tax liability. The full allowance of interest deductions to banks holding tax-exempt obligations contributes to the relatively low effective tax rates of banks. In 1981, prior to the changes reflected in current law, commercial banks paid only $926 million of Federal income tax on approximately $15 billion of net income.

In addition, the special rule for commercial banks and thrifts provides them with a competitive advantage over other financial institutions that are disallowed interest deductions for carrying tax-exempt obligations. Brokers and dealers currently are not allowed to deduct any portion of the interest paid to purchase or to carry tax-exempt securities. Similarly, life insurance companies must prorate their tax-exempt investment income between policyholders and the company, which is comparable to denying a deduction for interest incurred to carry tax-exempt obligations.

Proposal

Banks, thrifts and the other financial institutions favored under current law would be denied a deduction for 100 percent of their interest payments allocable to the purchase or carrying of tax-exempt obligations. The portion of a financial institution's interest payments that would be deemed allocable to the purchase or carrying of tax-exempt obligations would be the same as under current law. Thus, such portion would be equal to the ratio of (i) the average adjusted basis over the year of all tax-exempt obligations (acquired on or after January 1, 1986) held by the financial institution to (ii) the average adjusted basis over the year of all assets held by the financial institution. For example, if a bank holds $1,000,000 of tax-exempt bonds acquired after January 1, 1986, (measured by their average adjusted basis over the year) and $3,000,000 of other assets (similarly measured), its otherwise allowable interest deduction would be reduced by 25 percent without regard to whether paid to depositors, short-term obligors, or long-term obligors. The prorata presumption would be irrebuttable.

Effective Date

The proposal would be effective for interest allocable to tax-exempt obligations acquired on or after January 1, 1986. The current disallowance rule of 20 percent would continue to apply after December 31, 1985 to tax-exempt obligations acquired between January 1, 1983 and December 31, 1985.

Analysis

The deductibility of interest paid to purchase or to carry tax-exempt bonds increases the attractiveness of tax-exempt obligations because of the attendant opportunity to shelter other taxable income. Moreover, present law encourages banks to make investments that are not economically attractive except for the tax benefits. For example, a bank may borrow at a nine percent interest rate and invest in tax-exempt obligations yielding only seven percent interest. Economically, the bank would lose two percent on such a transaction; however, because the bank can deduct 80 percent of the interest paid, it pays an after-tax interest rate of only 5.7 percent

(9 x [1 - (.46 x .8)]) and makes an after-tax profit of 1.3 percent. Denying banks a deduction for interest allocable to the purchase or carrying of tax-exempt obligations would eliminate a tax incentive to make an otherwise unattractive economic investment.

Commercial banks hold one-third of outstanding tax-exempt securities and loans, as shown in Table 1. Commercial banks are the largest institutional investors, and are second only to households in total holdings of tax-exempt obligations. Commercial banks are the major institutional investors because of their ability to borrow funds and deduct interest to carry investments that earn tax-exempt income. The transitional rule would continue to allow banks to deduct interest attributable to bonds acquired prior to the effective date, so that there would be no incentive to sell existing holdings. Banks would continue to buy some tax-exempt bonds after the effective date as evidenced by the current holdings of life insurance companies and brokers and dealers, who are already subject to the proposed rule.

Viewed in isolation, this proposal would tend to reduce bank demand for tax-exempt bonds and exert upward pressure on tax-exempt interest rates, particularly short-term yields. Several of the Treasury Department proposals, however, would affect the interest rates of tax-exempt obligations. The aggregate impact on tax-exempt interest rates is uncertain because the elimination of non-governmental tax-exempt bonds, bonds issued for arbitrage purposes, and other tax shelters would tend to increase demand for the remaining governmental bonds and exert downward pressure on the interest costs paid by state and local governments.

Table 1

Distribution of Tax-Exempt Securities and Loans -- 1983

	Outstanding Tax-Exempt Bonds Amount (In Billions)	Percent
Households	$173.8	35.9
Nonfinancial Corporate Businesses	4.2	0.9
State and Local Government General Funds	9.7	2.0
Commercial Banks	162.4	33.5
Savings and Loan Associations	0.9	0.2
Mutual Savings Banks	2.2	0.4
Mutual Funds	31.5	6.4
Life Insurance Companies	10.0	2.1
State and Local Retirement Funds	1.8	0.4
Other Insurance Companies	86.7	17.9
Brokers and Dealers	1.4	0.3
Total	$484.6	100.0

Office of the Secretary of the Treasury
Office of Tax Analysis

November 30, 1984

Source: Board of Governors of the Federal Reserve System, Flow of Funds Accounts, Assets and Liabilities Outstanding, 1960-83

REPEAL TAX EXEMPTION FOR CREDIT UNIONS

General Explanation

Chapter 12.03

Current Law

Credit unions are exempt from tax on their income, whether such income is retained or distributed to depositors.

Reasons for Change

Because of their tax exemption, credit unions enjoy a competitive advantage over other financial institutions such as commercial banks and savings and loan associations. Their tax-exempt status has enabled credit unions to grow rapidly since 1951, when savings and loan associations and mutual savings banks became subject to the corporate income tax. Credit unions accounted for 5.7 percent of small time and savings deposits and 13.8 percent of consumer installment credit outstanding in 1983.

In an economy based on free market principles, the tax system should not provide a competitive advantage for particular commercial enterprises. Credit unions should thus be subject to tax on the same basis as other financial institutions.

Proposal

The tax exemption for credit unions would be repealed. Credit unions would be subject to tax under the same rules that apply to other thrift institutions.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

Tax exemption at the company level allows credit union customer/owners to defer tax liability on earnings retained by the credit union. By retaining their earnings tax-free, credit unions can offer their customer/owners higher rates of return than other financial institutions. Repealing the tax exemption of credit unions would eliminate the incentive for credit unions to retain, rather than distribute, current earnings.

The proposal will subject credit unions to tax on their retained earnings. To the extent that retained earnings are necessary for growth, credit unions will have to increase the spread between their "dividend" rates and loan rates to cover the Federal tax liability in the same manner as stock companies. As with other mutual depository institutions, however, credit unions could reduce the amount of Federal income tax paid at the corporate level by distributing more "dividends" to depositors or by providing lower loan rates to borrowers. Distributions of earnings would be included in taxable income currently at the individual level.

In 1983, Federal credit unions earned $4.0 billion in net income and distributed $3.6 billion in dividends or interest refunds to customer/owners. Retained earnings, which are tax-exempt and accrue tax-free interest income, were 10.6 percent of current net earnings. Some of the retained earnings would be distributed currently and taxed at the individual level; the remaining amounts would be subject to tax at the company level.

REPEAL REORGANIZATION RULES FOR FINANCIALLY TROUBLED THRIFT INSTITUTIONS

General Explanation

Chapter 12.04

Current Law

Certain acquisitions of the stock or assets of one corporation by another qualify as tax-free reorganizations under current law. In general, the shareholders of a corporation that is acquired in a reorganization may exchange their stock for stock of the acquiring corporation on a tax-free basis. In addition, a corporation acquired in a reorganization may exchange its assets on a tax-free basis for stock of the acquiring corporation.

Corporate acquisitions generally do not qualify as tax-free reorganizations unless they satisfy the "continuity of interest" requirement. Stated generally, an acquisition will satisfy the continuity of interest requirement only if the shareholders of the acquired corporation receive a significant, continuing equity interest in the acquiring corporation.

Special rules enacted in 1981 permit the acquisition of a "financially troubled" thrift institution to qualify as a tax-free reorganization without regard to the continuity of interest requirement. The continuity of interest requirement would generally pose an obstacle in such an acquisition because depositors are the only persons holding interests in the financially troubled thrift who would receive an interest in the acquiring corporation. Because of their insured position, however, the depositors in the failing thrift generally will not accept an equity interest in the acquiring corporation with its attendant risk of loss. For this reason, the acquiring corporation ordinarily will assume the failing thrift's liabilities to its depositors. In the absence of the special waiver, an interest as a depositor would not satisfy the continuity of interest requirement.

For the special rule to apply, the Federal Savings and Loan Insurance Corporation (FSLIC), Federal Home Loan Bank Board (FHLBB), or, where neither has supervisory authority, an equivalent State authority, must certify that the transferor thrift is insolvent, that it cannot meet its obligations currently, or that it will be unable to meet its obligations in the immediate future. In addition, the transferee must acquire substantially all of the transferor's assets and must assume substantially all of its liabilities. If an acquisition of a failing thrift institution satisfies these rules, the tax attributes of the failing thrift survive the acquisition and the acquiring corporation can use the net operating losses of the acquired thrift to lower its own taxable income.

In addition to the special reorganization rule, present law provides an exclusion from income for payments by the FSLIC to a thrift institution in connection with a reorganization. Such payments are not included in the thrift's gross income and do not reduce the thrift's basis in any of its assets.

Reasons for Change

The special rules governing reorganizations of financially troubled thrift institutions were enacted in 1981 to facilitate mergers and reorganizations of the then-ailing thrift industry. In such acquisitions, a profitable financial institution typically agrees to assume a failing thrift's obligations in consideration for payments from a regulatory body, such as the FSLIC, and the right to utilize the failing thrift's tax losses.

Thrift institutions and their shareholders should be subject to tax on the same basis as other business enterprises. The special rules for reorganizations of financially troubled thrift institutions depart from that objective, and effectively shift some of the burden of thrift losses to the Federal government. If such subsidization of reorganized financial institutions is necessary, it should be effected through direct appropriations. This would permit the appropriate regulatory agency to determine the need for and amount of a subsidy on a case-by-case basis.

Proposal

The special reorganization rules for acquisitions of financially troubled thrifts and the exclusion from income of FSLIC payments to thrift institutions in connection with a reorganization would be repealed.

Effective Date

The repeal of the special reorganization rules would be effective for acquisitions occurring on or after January 1, 1986. The repeal of the exclusion for certain FSLIC payments would apply to taxable years beginning on or after January 1, 1986.

Analysis

The Federal assistance provided through special tax rules hides the total subsidy cost and is likely to exceed the amount of assistance that would otherwise be provided through direct appropriations.